DOW THEORY LETTERS INC.

RICHARD RUSSELL
P. O. BOX 15196
SAN DIEGO, CALIFORNIA 92115

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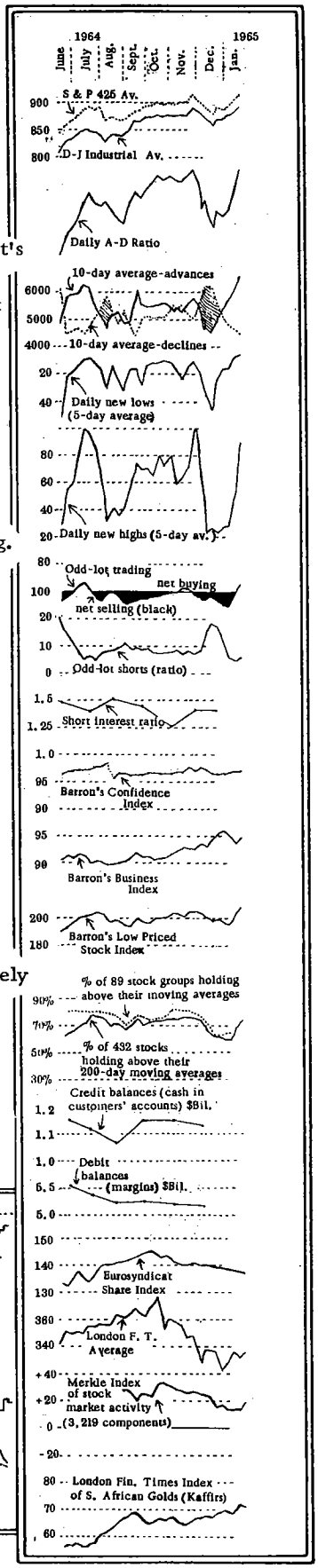
ENTER 1965: Over the past few months the rate of subscriptions here (both new and renewals) has climbed to the highest level in three years. While this is gratifying, the reasons behind it are hardly comforting. Many intelligent investors are worried, and they are making every effort to find out what is really going on. They are worried about their savings, their investments, their possessions and about the future of the dollar. In my opinion, much of the interest in stock market (and other) profits which existed prior to 1962 has now given way to a concern about preservation of assets. From phone calls, letters and conversations I gather that a great many people are particularly fearful about our Government's monetary policies, they are fearful of unbridled inflation, they are uneasy about the proposed reduction in the 25% gold clause. People are attempting to protect themselves against a shrinking dollar, against a President and Congress with the most grandiose spending plans in history, against a Treasury and a Federal Reserve who have for all intents and purposes become cogs in a great inflationary machine.

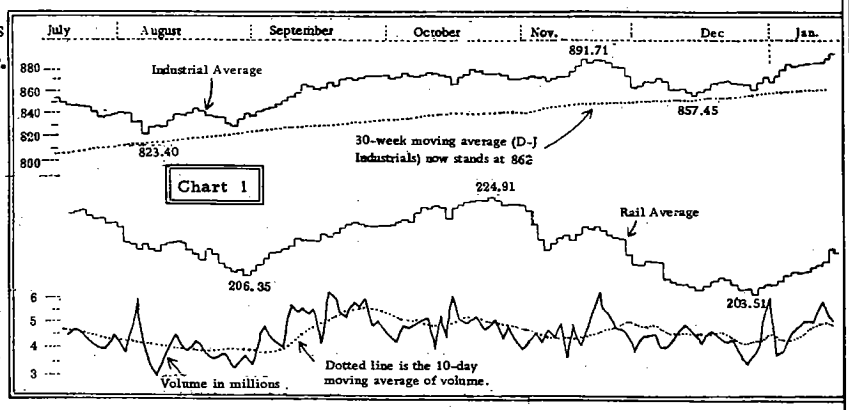
What should we as investors do? If we sit with dollars and cash savings, they may be eroded away. If we hold stocks, we find that on balance they now very easily produce about as many losses as gains. The real estate market is becoming treacherous and houses are no longer inflation hedges or even easy to sell. Gold stocks are a hedge against possible devaluation, but there is a limit to how much of one's money one should put into gold issues. If we hold a diversified position of part gold, part stocks, part real estate and part cash we are at best going to be only part right — and we could be partly very wrong. What is the answer?

In this writer's opinion, the best answer is a reliance on the wisdom of Dow's classical Theory. Dow's Theory may not be completely satisfactory, but it tells us that bull markets follow bear markets and that bear markets have always followed bull markets. It tells us that this bull market is ancient by all standards, and that in all probability it will be followed by a bear market which will have some relationship (in size) to the great 1949-196? bull market. Dow's Theory tells us that "no tree grows to the sky," even though for thousands of years men have wished and predicted otherwise. The Theory tells us that bull markets grow old and die, and that a bull market's demise usually occurs when least expected — often in the face of glowing polemics from businessmen, politicians and even the President himself. The Theory tells us that this bull market is reaching the stage in which Dow Theorists start building their individual "storm shelters." Whether the storm shelter should consist of all cash or Treasury bills; mostly bills and part gold shares; some bills, some gold issues and some common shares (the latter for the ride to the final top) I do not know. My own guess is that about 10% in golds, about 70 or 80% in cash, and the rest in common shares would be about right. My bet also is that when the ultimate change in the primary trend arrives, we will see massive deflation, and that this will completely confound most of the world which is now convinced (and fully prepared for) perpetual inflation. With all this in mind, I will now turn to the more immediate situation which is the still "live and kicking" bull market of today.



THE MARKET: A trend is considered to remain in force until proved otherwise. The last trend (and bears should keep this in mind) was bullish. The Rail Average (see Chart 1) recorded its high of 224.91 in October. Rails then declined about 10% to 203.51 on December 29, and they have been creeping higher ever since. The Industrial Average struck its high of 891.71 in November. Industrials then declined about 5% to a December 15 low of 857.45, and on January 18 they rose to a new all-time high.

In duration, the October-November decline fell within the required specifications for a secondary reaction. In extent,



the decline was subnormal as far as secondaries are concerned. Nevertheless, this writer accepts the October-November retreat as a mild secondary reaction, and obviously the rally since the December lows constitutes a full retracement of the reaction.

From the standpoint of Dow's Theory, the implications of the recent market action is clear enough. We should consider the market to remain bullish in a primary sense as long as one or both Averages hold above the December lows. Furthermore, if it is a bull market, then by definition the Averages will (in due time) push to new highs.

What would be required of the Averages to signal a change in the primary trend from bull to bear market? If during the period ahead Rails fail to better their old highs (224.91), and the two Averages then turn down and break the December lows (857.45 and 203.51) on heavy volume, I would then conclude that the primary trend had turned from bull to bear.

Short Term: As this is written, Rails have risen on 11 out of 12 days; they should therefore be ready for at least a minor correction. At the same time, Industrials have hurdled their November (891.71) high. The market appears temporarily "overbought" and the Rails may be saying that it needs a rest. If volume dries up on the next decline, the picture will appear quite bullish.

The Composite chart shows the S & P 425 Industrial Average flirting with its November all-time high while the DJIA is at a new high. The A-D ratio is also within a fraction of a new high, so that the only potential "fly in the ointment" is the possibility that the Rail Average (see Page 1) may not confirm. The 10-day averages of advances and declines shows an "overbought" situation, but this may be only temporary. New lows have retreated sharply (and bullishly) while new highs are rising towards their previous 100 mark. Odd-lots are displaying their customary January reinvestment enthusiasm, and no bearish conclusions can be drawn from this "normal" New Year behavior. Barron's Low-Priced Stock Index has pushed to a new high of 208.2, and this too is a bullish manifestation. The percentage of 432 stocks holding above their moving averages has leaped to 75%, a sharp improvement over the past two weeks and an indication of broad strength in the market. While the Eurosyndicat Index continues its desultory performance, the London F. T. Average appears ready to correct the entire decline (a move which will be signalled by a closing around 340). Finally, with this issue I have added the Kaffirs gold index which is a measure of the price of 30 S. African gold shares. The movements of this index may be considered a fair barometer of international worry or complacency regarding the world monetary situation. When Europeans are worried about their currencies, they often turn to the gold shares as a haven, and for this reason the Kaffirs index should be watched carefully.

Conclusion: Although a few indicators such as the Confidence Index (which recorded its high months ago) and the debit loans (which turned down last November) are not confirming the picture, there is no question but that the bullish forces are still master of the situation.

* * * *

Question: The U. S. is going to remove part of the 25% gold clause; it is going to rescind the gold backing behind the commercial bank reserves, thus leaving only the 25% gold backing on paper money (or Federal Reserve Notes). How will this affect investors and the nation? Answer: This will release an additional $6.7 billion of gold for foreign claims, thus taking pressure off the U. S. gold position for a while. That some such measure was absolutely assured could be seen from the chart on Page 5, Letter 276.

Question: If there were to be a multi-nation agreement regarding a rise in the price of gold, how would this affect the average American? Answer: There would probably be no direct affect at all. A multi-lateral price rise for gold would enlarge the world's gold base, but this would obviously allow for more potential inflation. Therefore, world devaluation might be taken as (at least temporarily) inflationary.

Question: On TV, on the radio, in the newspapers, through bank letters we are told that everything is all right, that the price of gold will not be raised, that Britain is taking a turn for the better, and that the monetary crisis is over. Why are we being bombarded by so much heated propaganda? Answer: I enclose a portion of a N. Y. Times article (January 5), and this sheds some light on the situation. It boils down to this: If you loaned a man a large amount of money, and the man started running through that money at an alarming rate, would you then announce to that man's creditors that he was a spending fool, or would you wipe the sweat off your upper lip, smile and tell everybody that "old Freddie has everything well in hand."?

Question: Has the gold problem been solved by the U. S. via a removal of the 25% clause? Answer: The question is not whether the U. S. is buying time by getting nearer and nearer to "paper dollars," the question is what is happening in Britain? Britain is the immediate crisis area, and what happens there during 1965 could be more important for the dollar and for gold stocks than what happens here.

$1 Billion Aid Funds Used Up by Britain

By CLYDE H. FARNSWORTH
Special to The New York Times

LONDON, Jan. 4 — Britain last month ran through a $1 billion aid package and started tapping a $3 billion package to defend the pound sterling, informed sources said today.

Britain is running a race with time in an effort to solve her balance-of-payments problems. Britain borrowed $1 billion from the International Monetary Fund and $3 billion from other nations in order to defend the pound. The $3 billion was a short-term loan and will have to be repaid in a matter of months. On January 5 the N. Y. Times reported that Britain had run through the I. M. F.'s loan and was chewing into the $3 billion package. It is probable that the 11 nation consortium which loaned Britain the $3 billion is now also doing some "chewing" — on their respective fingernails. For despite high sounding words, Britain is doing little to bolster confidence in her "competitive efforts." During Mr. Wilson's "first hundred days" he has alienated half the world, his 15% surcharge on imports has Europe up in arms, and he has in general been absurdly graceless in dealing with other nations. As a leading Tory recently put it: "Domestically, his (Wilson's) deeds have been right when the words were all wrong. It is all right to raise the bank rate to 7% — we did it twice in 1957 and 1961. But the increase must hurt, and you must mean it to hurt if it is to succeed. You must not say it is only for a few weeks and that it will not apply to certain building loans. If you put a surcharge on imports, you must not say that it will come off in a few months, for that will simply delay transactions. The words made nonsense of the deeds." But it is upon the deeds that the fate of the pound and perhaps the dollar hang.

Actually, over the past few weeks Britain has shocked knowledgeable students by granting an 86% pay boost to members of the House of Commons and by granting a 9% rate raise to British railroad workers. It would seem that Wilson, a socialist with an obvious penchent for doing nice things for everybody, is unable to grasp the seriousness of the situation. Wilson's prestige with central bankers throughout Europe is, in fact, now nearing the zero level. I suggest that all subscribers read the article "Backward Britain" which appeared in the January 13 Wall Street Journal. This piece documents the incredible economic situation in Britain, a situation which this writer believes will bring trouble to the pound and then the dollar.

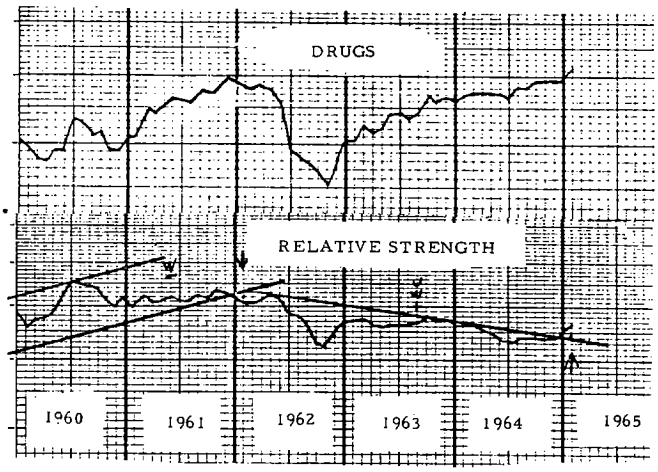
And standing behind the curtain of the "monetary troubles" is the figure of DeGaulle. Even Life Magazine (January 8) saw fit to present a full-length feature article entitled "What To Do About DeGaulle?" Significantly, this fairly worksmanlike article omitted the entire fiscal side of France's "war with the Anglo-Saxon countries." However, with a half-humorous question, Life (noting the seriousness of the DeGaulle attack) asks: "And what if DeGaulle is right? What if the proper question is, 'What to do about Johnson, Erhard and Wilson?'" Thus does Life pay homage to the gathering power of France.

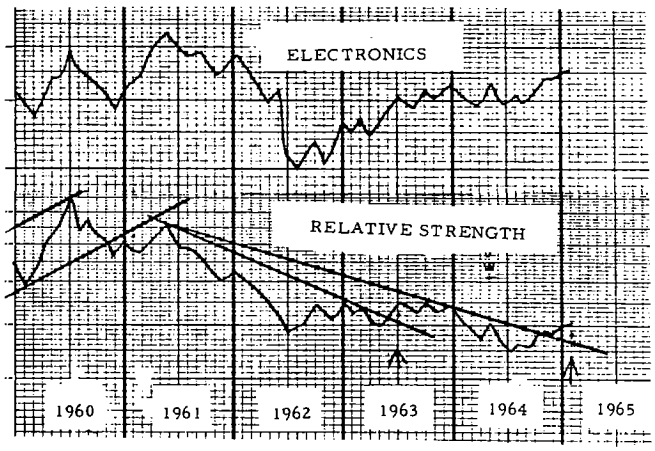
Actually, what is DeGaulle trying to do? On January 6 it was announced that France's reserves of dollars and gold reached a record high of $5.1 billion. At the same time, France replaced the dollar with the franc as the unit for reckoning for her own reserves. Next, France announced that she was not only increasing her monthly withdrawals of U. S. gold, but that she was going to withdraw a lump sum of $150 million in gold. Significantly, the gold is not to be simply "re-tagged" in the N. Y. Federal Reserve Bank vaults (the usual process), it is to be shipped to France. In effect, DeGaulle is implying that the franc is on the way to becoming a reserve currency. He is implying that gold is no longer safe in the U. S. He is literally saying to the rest of the world: "Gentlemen, follow the General. I am walking towards the exits as far as the dollar is concerned, and is you have any sense you'll do the same." In other words, DeGaulle is telling Germany with its $2.2 billion, Italy with its $1.3 billion, Switzerland with its $1.1 billion, Belgium with its $400 million, etc., to start getting out of dollars. DeGaulle is employing psychological warfare against the dollar and the pound, and this is the reason that he did not call in his entire $1.3 billion — he simply does not want to use up all his ammunition.

Finally, it is interesting to note President Johnson's lack of interest in foreign affairs. During his State of the Union speech there was a fleeting mention of Viet Nam — that was all. Johnson's reticence was discussed in the January 8 Wall Street Journal: "Johnson's shying away from foreign entanglement dismays top diplomats. They sense growth of 'isolationism by default,' danger of withdrawing too far." Actually, it is ironic that the U. S. has produced a President who dislikes foreign affairs — just when foreign affairs have taken their most important turn since World War II. If you watch the headlines, you will note that more and more of the "news" and the important international announcements come from Europe and Asia — while the U. S. reacts rather than acts.

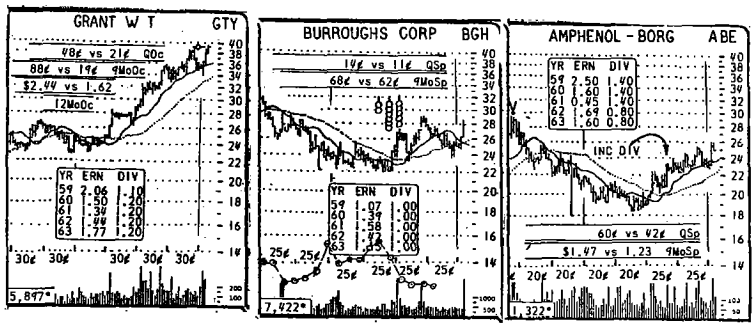
This then is the picture that I see for 1965. President Johnson, a man who is most comfortable when he is "home on the range," pitted against one of the shrewdest and most ambitious European strategists since Talleyrand. We can expect many of 1965's major news stories to arise from DeGaulle's efforts to establish his "third force" or even to elevate himself as leader of the Free World.

STOCKS: According to Ray * Signals of 161 B'way, N.Y.C. 6, (they keep the most extensive relative strength charts in the country) two stock groups have turned "favorable" for January. These are Drugs and Electronics. I have included Ray * Signal charts of these two groups. Note that the Drugs (mentioned in the last Letter) touched their peak of RS in 1960 and have actually been declining in popularity ever since. Over the past month this group appears to have reversed this trend. I continue to like Carter Products (see last Letter) in this group, and I also like Parke Davis. In the Electronics group, we note that the peak of RS was also established in 1960, and this represents the second attempt (the first occurred in 1963) to reverse this group's unfavorable RS line. A stock which I like in the Electronics group is Amphenol-Borg, a chart of which appears on Page 4. ABE has followed the group, showing a topping out of RS in 1960 and a topping in price in 1961. The stock has undergone four years of correction, has formed a large base extending back to 1962, and now shows a point & figure "projection" to 34. The small weekly chart shows ABE pushing out above its 10-week moving average (MA) which in turn is holding well above the 200-day MA (dotted line).



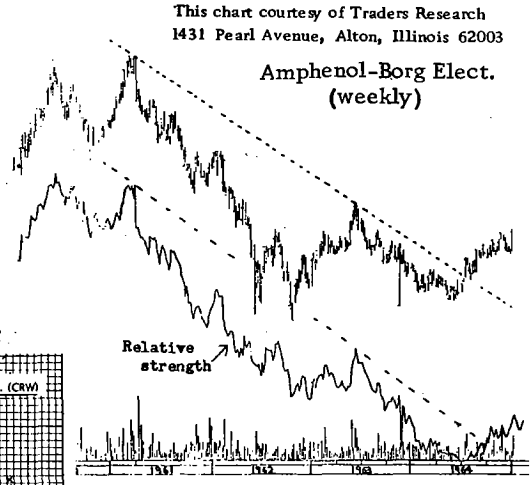


In reviewing the action of hundreds of stocks, I have concluded that many of the individual stocks which I previously recommended still look as good as any. Burroughs (first recommended in Letter 257) has finally climbed to the 28 level and volume was big (chart Page 4). Subscribers who bought BGH have had a long wait for their 4 points, but I would continue to "sweat this stock out." W. T. Grant was recommended in Letter 259 at around 31 has now climbed to 39 near its all time high (see chart Page 4). Sell half here, and ride out the rest. I recommended Phillips Petroleum and Rohr Aircraft convertible bonds in Letter 262. The Rohrs are up slightly and the Phillips look

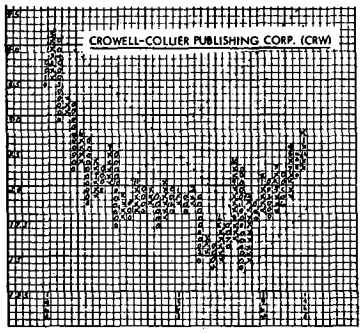


Small charts at right are courtesy of Quote Digest, 110 N. Lorraine, Wichata, Kans.

This chart courtesy of Traders Research
1431 Pearl Avenue, Alton, Illinois 62003

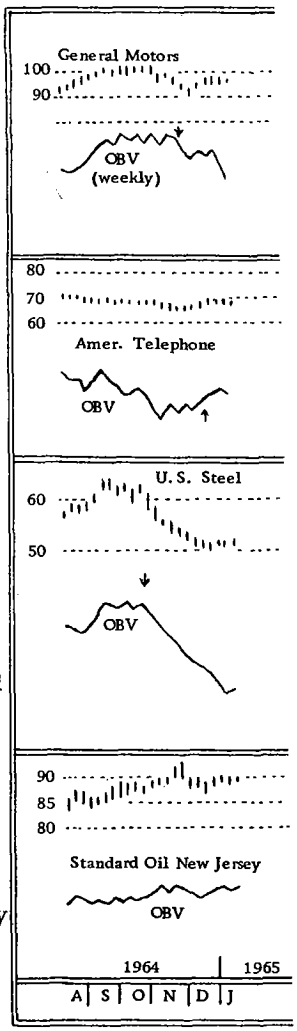


good and are up about 6 points ($60 per bond). Switch the Rohr to Phillips here, or if you do not have Phillips and want a play on a stock that acts well, I suggest purchase of P bonds in the 120-122 range. These are top rated convertibles, and you can buy them with little equity if you wish. Phillips is showing a "breakout" in earnings, and the bonds should be a good upside hedge even if bought here. I continue to like Crowell-Collier recommended in Letter 265 at 26. Although the stock is only up 2 points since then, it has climbed to a new high on a very impressive expansion in volume. Earnings are up sharply for CRW, and I include a P & F chart showing the huge base on CRW, a base which is wide enough to give an upside "count" or projection of 45 for this issue.



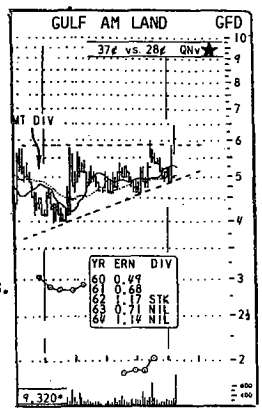
I have received many inquiries about my friend Joseph Granville's now-famous OBV theory. In general, this theory states that volume tends to precede price. In other words, volume is often a good gauge of how much money is going where, and it was further reasoned that if one can keep a "count" of upside and downside volume, one might know whether money is going in or out of a stock. Granville concluded that a continuing upside-downside volume line would be the best way to show what was happening in volume of an individual stock. In other words, Granville keeps a volume line on a stock in the same way that we keep an advance-decline line of daily breadth. If a stock trades 1000 shares and moves up, we add 1000. If it trades 3,000 shares next day and moves down, we subtract 3,000.

I have included charts of four of the giants in the D-J Industrial Average, with weekly OBV lines on each (weekly volume figures are used, although daily figures would be more accurate). What these OBV lines show is most interesting. Granville uses upward and downward zig-zags as being indicative of at least secondary turns in OBV and he attaches primary importance to new highs or new lows in the OBV lines. Thus we see that GM looks surprisingly poor from an OBV standpoint, its OBV line having recently zig-zagged down to a low for the past few months. Telephone would appear to be in at least a secondary OBV rise. U. S. Steel shows steady and unabated liquidation from an OBV standpoint, and Standard of Jersey's OBV line if anything shows stronger than its price line. Where OBV leads price, it is best not to go against the OBV line. Thus if OBV keeps dropping, the stock is probably weak and under distribution even though its price tends to hold. Conversely, a steady rise (or a new high in OBV) is bullish, regardless of whether a stock appears sluggish or even declines slightly.



It is quite simple to keep OBV lines on your favorite issues, and I recommend such procedure. I keep weekly OBV's on the four stocks listed above, and this gives me a view of what is occurring in four issues which represent a huge chunk of the U. S. economy. (Note: the definitive OBV book, "Granville's New Key to Stock Market Profits," is available from this office at $12.50).

Follow-up on golds: the potential correction in golds which was discussed in Letter 275 is now underway. So far, none of the Canadian golds have even declined to their 10-week MA's, and of course the 10-week MA's are more sensitive (and thus at higher levels) than the 200-day MA's. For the record, the following are the 10-week and 200-day MA's on leading golds: CRK 20 and 17; Dome 35 and 31; Homestake 49 and 46; Amer. S. African 42 and 38; GYK 15 and 13. The golds may have a long "cooling off" period after their recent upside explosions, but I believe they will gather strength to move out again.



AMEX SPECULATION: The A-D line on the Amex is undergoing its sharpest advance since late 1962. This could be the beginning of a broadening out in speculative interest. My favorite speculative issue on the Amex is Gulf-American land, an outfit with large holding in Florida and Southwest land plus hotel interests. Two directors bought 12,000 shares of this stock in November. Note the large ascending triangle on the weekly chart, and the current breakout on volume. My friends in New York (who are buying GFD) tell me that this one is going to show sharply increased earnings.